DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0111; 01-0112
Indiana Corporate Income Tax
For the Tax Years 1996, 1997, and 1998

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ISSUES

I. **Service Income Received From Out-of-State Customers** – Gross Income Tax.

Authority: IC 6-2.1-2-2(a); IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 1-1-121; 45 IAC 1-1-121(a).

Taxpayers argue that the audit erred in determining that their income, derived from the out-of-state provision of services to Indiana customers, was subject to the state's gross income tax.

II. **Payroll Adjustment** – Adjusted Gross Income Tax.

Authority: 45 IAC 3.1-1-3; I.R.C. § 62.

Taxpayers argue that the audit, in calculating the taxpayers' Indiana adjusted gross income tax, erred in disallowing a portion of payroll expenses – purportedly attributable to the second taxpayer – reported on the first taxpayer's federal return.

III. **Abatement of the Ten-Percent Negligence Penalty**.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayers request that the Department of Revenue exercise its discretion to abate the ten-percent negligence imposed against both taxpayers at the time of the original audit reports.

STATEMENT OF FACTS

Both taxpayers are out-of-state companies and are both affiliate members of a larger group of related companies. Both taxpayers are incorporated in Ohio and conduct business from an Ohio business location. Both taxpayers provide their clients with bill collection services. Their clients include retailers, financial institutions, credit card companies, and telecommunications companies. Taxpayers and clients enter into agreements in which taxpayers agree to obtain payment for unpaid bills owed the clients. The taxpayers pursue the collection of the unpaid bills

by sending dunning letters and making phone calls to the debtors. According to taxpayers, these letter-writing and phone activities are conducted in Ohio.

During 1996, 1997, and 1998 the taxpayers took various and inconsistent views with regard to their Indiana gross income tax liability. For example, in 1996 taxpayers reported all collections related to Indiana customers as subject to gross income tax. In 1997, taxpayers reconsidered their position and determined that none of the Indiana service revenues were subject to Indiana gross income tax.

The Department of Revenue (Department) conducted successive audits (Hereinafter simply referred to as "audit.") of taxpayers' business records for the tax years 1996, 1997, and 1998. The audit concluded that taxpayers had "substantial nexus' with Indiana and that their Indiana activities subjected taxpayers' Indiana collection service receipts to gross income tax. The audit only considered receipts received from Indiana customers in calculating the taxpayers' gross income tax liability.

The audit was initially permitted to examine taxpayers' federal and state income tax returns. Certain correspondence was exchanged between taxpayers and the audit personnel in which the Department requested additional information. However, the audit concluded that – despite the information provided within the resulting correspondence – there "[was] insufficient information to accurately determine the source and activities of [taxpayers'] collection service income." Therefore, the audit reached its conclusions based upon the "best information available."

Taxpayers' disagreed with the audit's conclusions. Thereafter, taxpayers' representatives submitted a protest setting out numerous challenges to the audit's conclusions and to the amount of taxes assessed as a result of those conclusions.

An administrative hearing was conducted during which taxpayers' protest was discussed. It was agreed that three issues required resolution at the administrative level. This Letter of Findings addresses those three issues.

DISCUSSION

I. Service Income Received From Out-of-State Customers – Gross Income Tax.

Indiana imposes a gross income tax on income received by Indiana residents and by certain out-of-state residents. IC 6-2.1-2-2(a) states as follows:

> An income tax, known as the gross income tax, is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana; and (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident of Indiana.

Both taxpayers are registered to do business in Indiana; taxpayers admit, that in rendering their collection services, they are protected by Indiana law and "have the ability to file suits in

Indiana." In addition, taxpayers agree with the audit that they have "substantial nexus" with Indiana.

It is evident from the audit report that the Department was less than satisfied with the adequacy of the information received from the taxpayers during the audit investigation. The audit report noted that there was "insufficient information to accurately determine the source and activities of [taxpayers'] service income." Taxpayers disagree maintaining that they provided the Department with access to not only their state and federal returns but also the original work papers used in preparing those returns. Furthermore, taxpayers maintain that, on two separate occasions, taxpayers provided written answers to questions submitted to them by the Department.

Setting aside the issue of whether taxpayers fully cooperated with the Department or were wholly forthcoming in responding to the Department's request for additional information, it is apparent that the precise nature of taxpayers' business activities, taxpayers' relationship to the parent company, and the extent and nature of taxpayers' in-state activities remain to some extent unclear.

45 IAC 1-1-121 provides that "Gross income derived from the performance of a contract or service within Indiana is subject to gross income tax." The regulation points out that "Income from a contract for the performance of services within the State is subject to gross income tax. However if the contract calls for the performance of services both within and without the State by a nonresident with no in-state business situs and the non-resident's performance within the State is minimal or incidental in comparison to his performance out-of-state, no service income will be taxed." 45 IAC 1-1-121(a).

The regulation instructs that the income received by an out-of-state business for the performance of services is not subject to the state's gross income tax unless the business's activities within the state are more than "minimal or incidental" compared to those activities performed within the foreign state. To that end, the Department has set a benchmark figure for determining whether a business's in-state activities exceed the "minimal or incidental" threshold. The regulation states that, "If five percent (5%) or less of the total hours or total fee under the contract in any tax year is attributable to services performed in Indiana, the entire proceeds of the contract received in that year are exempt from gross income tax. If the five percent (5%) figure is exceeded, the entire proceeds of the contract are taxable." 45 IAC 1-1-121(a).

Taxpayer maintains that all of its phone calls are made from outside of the state and that all of its collection letters are prepared and then sent from outside the state. What has not been established are the nature and extent of the taxpayers' activities performed within the state. The audit report indicated that taxpayers were "vague in the answers and information provided" and that the "no general ledgers, no service billings, no notes or contracts, no detail of customers" were available for examination. After reviewing the information taxpayers provided during various stages of the audit investigations, it is reasonable to conclude that taxpayers' responses to the Department's questions outlining their Indiana activities are somewhat obtuse. For example, in response to a question of whether taxpayers' pursued collection activities against recalcitrant debtors within the state, taxpayers' representative stated that "Presumably, if either entity is registered to do

business in Indiana, they have the ability to file suits in Indiana." (Both entities are registered with the Indiana Secretary of State to do business within the state.)

It is apparent from the available information that taxpayers engaged in certain activities within the state. However, whether those in-state activities constituted one percent, five percent, or 20 percent of the activities related to the acquisition of the Indiana source income, is an issue which cannot be resolved with any mathematical certainty from the information the taxpayers provided at the time of the audit, from the information contained within the original audit report, or from the information contained within taxpayers' initial protest letter. Accordingly, the audit did not overstep its authority under 6-8.1-5-1(a) in determining that taxpayers' Indiana source income was subject to the state's gross income tax. The statute plainly states that, "If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available." IC 6-8.1-5-1(a).

IC 6-8.1-5-1(b) provides that the assessment of gross income taxes is "prima facie evidence that the department's claim for the unpaid tax is valid." It is taxpayers' burden to demonstrate that the proposed assessment is wrong. Id. Taxpayers have failed to do so, and the Department is left with no alternative but to deny their protest.

FINDING

Taxpayers' protest is respectfully denied.

II. Payroll Adjustment – Adjusted Gross Income Tax.

In calculating its adjusted gross income tax, taxpayer one deducted an amount of payroll expenses which it had paid on behalf of taxpayer two. The audit disallowed the portion of the payroll paid on behalf of taxpayer two. Taxpayer one argues that it was entitled to the entire deduction because it had entered into an agreement with taxpayer two to serve as both companies' "common payroll master."

Pursuant to this agreement, taxpayer one made the payroll payments for taxpayer two. In return, taxpayer two forwarded a "service fee charge" to taxpayer one. Taxpayer one now argues that "there is no reasonable basis for [the] disallowance."

In support of its argument taxpayer one cites to 45 IAC 3.1-1-3 which states as follows; "The following deductions contained in Internal Revenue Code Section 62 are allowed in determining Indiana adjusted gross Income: (1) Trade and business deductions."

In turn, the federal code allows the taxpayer – calculating its adjusted gross income – to subtract from its gross income certain expenses "attributable to a trade or business carried on by the taxpayer . . . ." I.R.C. § 62.

In calculating its adjusted gross income, taxpayer one is plainly entitled to deduct from its gross income the amount of money it pays to its employees. The sum of money it pays to those

employees may be deducted because, under I.R.C. § 62, that sum represents a cost attributable to conducting its own collection business. However, there is no discernible authority under either 45 IAC 3.1-1-3 or I.R.C. § 62 which permits taxpayer one to deduct the amount of payroll paid on behalf of a second entity. Taxpayer one's secondary payroll costs are not one of the expenses incurred as a result of taxpayer one's collection business; these secondary payroll expenses – incurred as a result of its agreement with taxpayer two – are peripheral to the conduct of taxpayer one's business affairs.

FINDING

Taxpayers' protest is respectfully denied.

III. Abatement of the Ten-Percent Negligence Penalty.

Taxpayers ask the Department to exercise its authority and abate the ten-percent negligence penalties assessed at the time the audit report was concluded.
IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if a tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) permits the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayers' inconsistent stance regarding their Indiana tax liabilities and their circumspect provision of requested information does not exhibit the "ordinary business care and prudence" warranting abatement of the negligence penalty.

FINDING

Taxpayers' protest is respectfully denied.

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